EDISON

OTC Markets Group

Efficient US securities marketplaces

Initiation of coverage

Financial services

OTCM provides regulated marketplaces offering a cost-effective solution for targeting US investors. Issuers wanting an informed and efficient US market face less regulatory complexity and so incur lower costs. Its advanced electronic network model is low cost to traders by eliminating the middle man. This model, combined with high-quality, advanced-technology service has seen strong growth especially from international issuers. Despite challenging market conditions, it has grown revenue, much of which is non-market sensitive, every year since 2007.

Year end	Net Revenue ($m)	PBT* ($m)	EPS* ($)	DPS ($)	P/E (x)	Yield (%)
12/11	30.8	7.0	0.45	0.16	17.8	2.0
12/12	33.2	9.0	0.51	0.45*	15.7	5.6
12/13e	37.3	10.5	0.58	0.22	13.8	2.8
12/14e	41.9	12.2	0.67	0.24	11.9	3.0

Note: *PBT and EPS are diluted and adjusted for the effects of restricted stock awards. *includes special dividend.

Marketplaces platform

OTCM is not an exchange, it is a technological network providing an "Open, Transparent and Connected" market saving issuers compliance costs and traders dealing costs. Issuers range from US SMEs to global names such as Roche. OTCM offers three tiers of marketplace, with its highest-tier companies having exchange-comparable standards. OTCM generates revenue from: (i) OTC LINK ATS trading services (33% of 2012 revenue), mainly from charging brokers fixed monthly subscriptions with some variable month user and usage fees; (ii) market data licensing (39% of 2012 revenue), mainly from monthly fees from distributors such as Bloomberg; and (iii) issuer services (28% of 2012 revenue), mainly from annual information and communication services contracts to issuing corporates.

Why issuers use OTCM

OTCM's marketplaces provide issuers with simple, technologically-advanced, regulated marketplaces, well connected to the investor and press communities, at a low cost. For broker-dealers, the SEC registered ATS trading systems are exchange equivalent in service but have lower intermediary costs.

The key sensitivities

The key sensitivities are regulation and technological development. Both present OTCM with challenges and opportunities. Current proposals to ease some of the rules for small US companies could see greater demand to have their securities traded. There are market volume related revenues, but these are quite modest.

Valuation: Not paying full value for growth

OTCM is very profitable (c 40% ROE), has strong forecast growth (c 16% CAGR 2012-14) and generates cash (over $4m+ pa), and yet it trades on a 2013 P/E of just 14x. We believe this is partially due to low stock liquidity. Our conservative valuation approaches indicate a fair value of around $10.7.

27 March 2013

Price	**US$8**
Market cap	**US$85m**

Net debt/cash ($m)	13.6
Shares in issue	10.8m
Free float (company basis)	59%
Code	OTCM
Primary exchange	OTCQX

Share price performance

%	1m	3m	12m
Abs	(1.1)	6.5	23.1
Rel (local)	(5.3)	(3.3)	11.5
52-week high/low		US$8.1	US$6.4

Business description

OTC Markets Group (OTCM) operates a marketplaces platform directly linking a diverse network of broker-dealers that provide liquidity and execution services in almost 10,000 equity and debt securities. OTC LINK ATS is an SEC-registered Alternative Trading System (ATS).

Next events

Presentation, Edison London office	16 April 2013 at 4.30pm
Q113 results	Mid-May

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Edison profile page

OTC Markets Group is a research client of Edison Investment Research Limited

Investment summary

Company description: "Open, Transparent and Connected" financial marketplaces

OTCM manages a number of marketplaces offering a low-cost and low-regulation option for companies wanting to have a US market where their securities can trade. There is global demand for access to US investors and of c 10,000 securities traded on its platforms, OTCM has c 1,500 foreign issuers' American Depository Receipt (ADRs) and 1,500 foreign issuer ordinary shares accounting for over three-quarters of the dollar value traded. Revenues from TSX-listed Canadian companies accounted for c 11% of group gross revenue. The best companies, many of which provide considerable financial information and are compliant with many exchange listing requirements, use OTCQX (43 US companies and 338 foreign companies). This marketplace, which includes stocks such as Roche, Axa, BASF, and Marks & Spencer, has been a key driver to revenue in recent periods. OTCQB is the "venture stage marketplace" for c 3,300 companies that are current in their reporting with a US regulator but may not meet all the conditions of OTCQX. The third marketplace is called OTC Pink "The Open Marketplace", and has companies with a range of financial and other disclosures. Looking forward we see the international growth continuing and proposals to help smaller companies seeking greater domestic investor appeal and visibility. OTCM has three broad sources of revenue: (i) charging brokers fees to quote, message and trade these securities, (ii) charging for data and (iii) charging issuers for a range of services. We believe the key is that most revenue streams are recurring and we note that revenue has increased every year since 2007.

Valuation: Not paying full value for growth

OTCM is trading on a 14x P/E for a business expected to deliver 16% CAGR profit growth over the next few years. OTCM is strongly cash generative and our discounted cash flow approach indicates a valuation of c $11.5 a share. Our Gordon's growth model is more conservative (at $9.8). Share illiquidity is an issue.

Financials: Strong growth expected

Despite the financial crisis, OTCM has grown revenue every year since 2007, a trend we expect to continue. Its cost income ratio has been improving since 2010, which is another trend we expect to continue. We expect trading to be less important and both data related and issuer services to grow. The latter assumes continued growth in the international OTCQX customer numbers.

Sensitivities: Regulation, markets, technology

- Regulation on other markets: How exchanges are regulated is important, and ironically easing rules elsewhere would be unhelpful to OTCM.
- Regulation of OTCM is also important: There is a regulatory proposal (FINRA QCF), which if implemented would materially reduce the income OTCM earns from its data.
- Market confidence: Much of OTCM's income is recurring, but there is an element that is sensitive to the amount of trading investors have the appetite to do.
- Technology: OTC Link ATS is the platform on which trades are conducted and its technology is critically important.

Company description: "Open, Transparent and Connected" financial marketplaces

OTC Markets Group Inc (OTCM) operates "Open, Transparent and Connected" financial marketplaces for investors to trade almost 10,000 equity and debt securities linking a diverse network of over 130 broker-dealers that provide liquidity and execution services. Strong growth has been seen in recent years in the number of OTCQX securities, the highest income earning group, especially from international companies (with a significant representation of TSX Canadian companies). In 2012 more than $165bn (2011: $229bn) of dollar volume was traded in OTCM securities. OTCM accounted for $36bn 22% market share (2011: $45bn) trading 393bn individual shares. The securities in the OTC marketplaces include c 1,500 ADRs (2011: 1,200), c 1,500 foreign ordinaries (2011: 1,300). There are issues from nearly 700 community banks and nearly 2,700 companies that are current in their SEC reporting, as well as a wide spectrum of securities not found on exchanges. In 2012, over 95% of the dollar volume of securities traded on OTC Link ATS had current information available to investors. Data is disseminated to subscribers through 54 distributors (2011: 47) including the likes of Bloomberg, Interactive Data Corporation and Fidessa.

Exhibit 1: Breakdown of securities by OTCM-tiered marketplaces

	No of securities Dec 2009	No of securities Dec 2010	No of securities Dec 2011	No of securities Dec 2012	No of securities 14 Mar 2013
OTCQX US	17	21	29	44	43
OTCQX Int	61	138	285	356	338
OTCQX total	78	159	314	400	371
OTCQB **	3,321	3,851	3,625	3,401	3,388
OTC Pink (total)	5,879	5,954	6,227	6,173	6,228 *
Total	9,278	9,964	10,166	9,974	9,987

Source: OTCM Edison Investment Research. Note:*Of the OTC Pink current number, 2,673 were current Info, 472 Limited info and 3,083 No info basis. The drop in OTCQB is due to a market trend for companies de-registration. **Actual launch April 2010.

The strongest growth in recent years has been in the number of companies trading on OTCQX, the highest income earning group, especially from international companies. A seasonal drop is usual for Q1 given renewals take effect in January. This year the renewal rate was 87% (2011: 95%) with increased attrition especially in Canadian resource companies. We believe this is driven by larger companies trying to moderate higher regulator and compliance requirements post the financial scandal and consider this is likely to continue. OTCM has also taken the vast majority of the business from its main rival (OTC BB). We see opportunities for growth in proposals to reduce the regulation on smaller companies. There are many advantages in smaller companies having securities traded (including staff motivation, credibility with customers, company valuation etc), but currently compliance costs are high. Under the Jumpstart Our Business Startups Act, these could reduce and OTCM is a natural place for such companies wanting the low-cost option to have their securities traded.

Why use OTCM

The business model has several competitive cost advantages over exchanges.

- Issuers face lower compliance costs and complexity. Securities are traded, but OTCM is not an exchange. While heavily regulated (see below), this means corporates can establish a market for their securities without the burdensome costs and regulation associated with a listing. This is appealing not only to smaller companies where the costs of listing may be disproportionate, but also to global businesses who want access to the US market.
- Issuers also have access to OTCM's broad network with immediate full distribution to the US investor community and financial and market press. This visibility can be used to broaden a company's appeal.

- Traders face lower execution costs. Exchanges introduce intermediary costs while OTCM puts traders directly in contact with each other. The cost savings of not having an intermediary can then be shared. OTCM's network approach should also reduce search costs in that all the interested parties are on the same multi-sided platform and so they do not need to incur any costs in looking elsewhere. In a way it is like shopping on eBay rather than trailing round a number of shops.
- OTCM believes its network gives broker-dealers better control over the execution of its client's orders improving service levels, best execution and managing capital requirements.
- The connectivity established across the network has established critical mass in both securities and also broker-dealers, making it the primary place to deal in its securities (see completion section below). This is an important barrier to entry.

OTCQX: "The Best Marketplace with Qualified Companies"

OTCM has identified for investors those companies with good disclosure and that meet certain additional criteria. Given these conditions, these companies represent the lower-risk investments and often are companies that could be listed on a major US exchange but choose not to. OTCM believes less than 20% of its non-OTCQX customers would be eligible for OTCQX. As noted above, the key advantages of OTCM are lower costs and regulation, while the disadvantages are the inability to raise new capital, and the impact on credibility of not meeting listing requirements. With OTCQX representing less than 5% of securities traded there is considerable scope to up-sell this marketplace to existing clients and encourage them to take more services en route. Also, the network of advisers to issuing companies still has some years to mature, and we expect a further increase in securities on the marketplace as their distribution evolves.

OTCQX U.S./OTCX U.S. premier

Many US companies qualify for trading on OTCQX as the final step toward a NASDAQ or NYSE listing. Other US companies enjoy the efficient compliance-driven and cost-effective model it offers their investors outside of a traditional exchange listing. The key requirements for OTCQX U.S. are: (i) Ongoing operations (no shells, blank check or insubstantial special purpose acquisition companies); (ii) A minimum bid price of $0.10 (for preceding 90 business days); (iii) The company may not be subject to any bankruptcy or reorganisation proceedings; (iv) The company must be validly existing under the laws of each jurisdiction in which it is organised; (v) At least 50 beneficial shareholders, each owning at least 100 shares of common stock; (vi) Ongoing quarterly and audited annual financial reports posted on OTCQX.com or EDGAR; (vii) Inclusion in the Standard & Poor's Corporation Records or Mergent Manuals (Moody's Manuals); (viii) A Designated Advisor for Disclosure (DAD) Letter of Introduction upon application process completion and quarterly and annually thereafter to OTCM confirming that the issuer has made adequate current information publicly available and meets the OTCQX inclusion requirements.

OTCQX U.S. is the highest OTCM marketplace and adopted by nearly 50 US companies. Of these about a third are "OTCQX U.S. Premier", which is designed to identify issuers that are of the size and quality to list on a national stock exchange and has additional requirements of: (i) a minimum bid price of $1 (for the preceding 90 business days); (ii) at least 100 beneficial shareholders, each owning at least 100 shares of the company's common stock; (iii) meeting the financial qualifications for continued listing on the NASDAQ Capital Market; and (iv) annual shareholders' meetings.

Many OTCQX U.S. customers are emerging-growth companies that may be working to a full exchange listing but do not yet have the scale to support the full listing requirements. Others are seasoned companies looking to provide a quality marketplace for its securities. We understand the churn rate typically ranges between 5-15% pa, with premier customers being the most stable.

OTCQX International and OTCQX International Premier

A foreign corporation can opt out of not only the Sarbanes-Oxley Act, but also the voluminous filing demands of the Securities & Exchange Commission. OTCM estimates all told, the savings for a big firm fleeing a US exchange listing might run to $10m plus a year. There also may be some modest advantages in having a lower litigation risk relating to certain SEC reporting requirements. As with a listed ADR, a custodian receives the shares on the foreign market, holds them in custody and issues a negotiable security equivalent to those shares but which is traded on US markets as a US security (with all the tax, etc, implications). It trades in dollars and pays dividends in dollars, for small US investors avoiding the complications of currency conversion.

To qualify for OTCQX International a foreign firm must: (i) Have most of its shares trade overseas and have a security listed on one or more stock exchange in a foreign jurisdiction. (ii) Publish in English on its website its annual report in the form required by the laws of the country of incorporation, organisation or domicile. (iii) Have a Level 1 Sponsored ADR programme in the US, which requires a depositary bank, or a foreign ordinary that is Depository Trust Company (DTC) eligible F share (such as companies listed on a Canadian exchange). (iv) Have a qualified, third-party Principal American Liaison (PAL) sponsor to help it with the admission process, post disclosure in English, and be available as a trusted resource regarding all aspects of investor information needs and US market protocols. (v) Be included in the S&P or Mergent Manual for Blue Sky compliance, allowing brokers to sell the security in up to 38 states. The first two points were the result of a 2008 SEC easing of the rules exempting companies from registering their securities with the SEC and saw a material expansion in the number of ADR programmes. The latter points are OTCM-specific. OTCQX Premier has additional NASDAQ-like qualifications that typically are relevant for the largest companies.

The opportunities for OTCQX International are considerable. In BNY Mellon's market review, the 2012 Depositary Receipt yearbook, BNY Mellon noted the 2012 value traded in the top five listed programmes (Baidu, Vale, Petrobas, BP, Vodaphone) was over $450bn, while for OTCM its top five (Nestle, Roche, Gazprom, Tesco, BASF) was $19.2bn. The larger ADR programmes are level III (offering facility) or level II (listing facility) and have the advantages of allowing capital raising and exchange listing respectively, but if only a few companies currently incurring the costs associated with these listings were to change to level 1 status, the impact on OTCM could be material. In addition, we believe awareness of the OTCM option is still embryonic.

OTCQB: "The Venture Stage Marketplace"

OTCQB is the venture marketplace for companies that are current in their reporting with a US regulator. There are no financial or qualitative standards to be in OTCQB. OTCQB securities may also be quoted on the FINRA BB. The OTCQB allows investors to easily identify reporting companies traded in the OTC market regardless of where they are quoted.

OTC Pink: "The Open Marketplace"

OTC Pink, the third level of security, is divided into three further levels:

- OTC Pink Current: Companies that follow the Alternative Reporting Standard or the International Reporting Standard by making filings publicly available through the OTC Disclosure & News Service. There is a mix of companies on OTC Pink Current including, for example, Nestle. Issuers may chose this marketplace reflecting inter alia their appetite for engagement with US shareholders and the risk US distribution of information. It also includes shell or development stage companies with little or no operations as well as companies without audited financials.
- OTC Pink Limited: Designed for companies that make limited information publicly available, for example those with financial reporting problems, economic distress, or in bankruptcy or that

simply choose not to provide more. Companies in this category have limited financial information not older than six months available.

- OTC Pink No Information companies: Indicates companies that are not able or willing to provide disclosure to the public markets, OTC Pink No Information includes defunct companies that have ceased operations as well as 'dark' companies with questionable management and market disclosure practices. Management notes that publicly traded companies that are not willing to provide information to investors should be treated with suspicion and their securities should be considered highly risky.

OTC Link ATS Trading Services

The OTC Link ATS marketplace is provided through the OTC Link Alternative Trading System, which began operation on 1 June 2012. OTC Link ATS is operated by OTC Link LLC, a FINRA member broker-dealer, SEC regulated Alternative Trading System and wholly-owned subsidiary of OTCM. OTC Link ATS is now responsible for the vast majority of the trading services business line, including all quoting and messaging services, As a FINRA and SEC regulated entity, OTC Link ATS is required to comply with applicable regulations and undergo periodic examinations by the SEC and FINRA.

How OTCM generates revenue

Revenue has risen every year since 2007 (exhibit 3) and is relatively independent from trading activity. OTCM has developed a range of income lines across trading services (a mix of volume related and subscriber fees), market data licensing (subscriber based) and issuer services (Exhibit 4 below). The critical business message is that the majority of these revenues are relatively stable subscription types of business.

OTC Link ATS Trading services (33% of 2012 revenue)

OTCM charges broker-dealers a number of fees (typically layered by volumes), including (i) quote fee, charged per stock in which they make a market; (ii) messaging fees, which are charged on a layered basis, per security per day – the key driver is trading activity; (iii) a dealer application, charged by the number of authorised dealers and (iv) a view-only quoting service for non-market-making market participants (eg agency only brokers). Trading services generated $11.6m of revenue in 2012 (2011: $11.7m). The key units here are quote and message income (which has been increasing) and OTCM dealer licence subscriptions, which has seen some pressure as smaller, manual-trading brokers have been squeezed out of the market (2012 brokers numbers c 130, 2011: c 160). This revenue stream is sensitive to the macroeconomic environment, investors' confidence and the resultant trading volumes. There is also a small element of rebate to connectivity fees (c 0.3% of revenue).

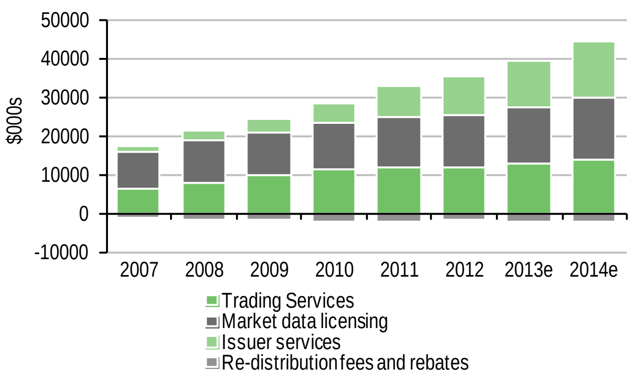
Market data licensing (39% of 2012 revenue)

OTCM's real-time market data distribution network includes all the major financial data distributors, such as Bloomberg (c 13% of group gross revenue), Interactive Data Corporation (5% of total group gross revenue), and Fidessa. It also encompasses online brokerages including Etrade, Fidelity, Schwab, Scottrade and TD Ameritrade. They typically pay monthly licence fees, which vary with the type of licence (different layers offering access to different types of data and different usages such as internal only or to clients etc). Redistribution fees and rebates are paid to some distributors and, after a recent favourable negotiation, these account for c 13% of market data licensing gross revenue (5% group revenue). Around two-thirds of this reporting unit's revenue comes from professional licences.

Issuer services (28% of 2012 revenues)

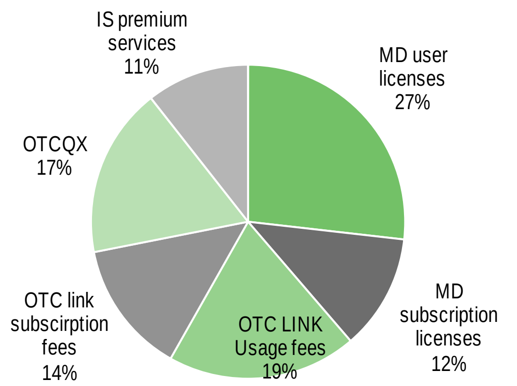
OTCM offers issuers a range of services including: (i) OTC Disclosure and News Services such as the dissemination of financial results. (ii) Compliance services including meeting a range of state requirements. (iii) Customer Support: Services range from helping understand listing requirements through to posting news releases to ensure timely informational, educational and regulatory updates. (iv) This unit also includes the advertising revenue generated from selling display advertisements on the OTCM website. OTCQX corporates pay an application fee of $5k and a recurring annual fee of $15k. With nearly 400 clients, the annual fee alone raises c $6m, over a fifth of group revenue. Premium services, used by less a tenth of issuers, in 2012 accounted for 11% of revenue presenting a material opportunity for up-selling.

Exhibit 2: Trend in Group Revenue



Source: OTC Markets, Edison Investment Research

Exhibit 3: Revenue split



Source: OTC Markets, Edison Investment Research

Management

As may be expected from a management team in financial services technology, the management team is young with an average age for management of under 40 and for directors under 50. There is a reasonable balance between experience with the company (average of eight years) and fresh thought (three of the eight have joined since 2010). R. Cromwell Coulson, president and CEO, in 1997 led a group of investors in acquiring OTCM's predecessor business, the National Quotation Bureau (NQB) and he still owns 4.2m Class A shares and 130k Class C shares.

The key front-line management are:

- Matthew Fuchs (Managing director, Market data and strategy) joined OTCM in 2007 with over 12 years' experience in the financial technology industry.
- Lisabeth Heese (Managing director, Issuer and information services) joined OTCM in 2004 as the director of issuer and information services. Prior to joining OTCM, Liz spent 11 years at NASDAQ.
- Michael Modeski (President, OTC Link LLC) joined OTCM in 2011 with over 15 years of experience in the OTC markets at Citigroup, FINRA (as director of OTC equities) and Pershing.
- Timothy Ryan (Managing director, Sales and business development) joined OTCM in 2005 with over 15 years of development experience at NASDAQ, The Portal Market, and OTCBB.
- Non-executive directors include Neal Wolkoff (former Chairman and Chief Executive Officer of the American Stock Exchange), Siggi Snorrason (former Head of Trading and Information Technology at the Iceland Stock Exchange), Louisa Serene Schneider (Columbia Business School, previously Morgan Stanley and JP Morgan) and Gary Baddeley (former entertainment group CEO).

Regulation

The OTCM and broker-dealers' activities in the market are regulated by the Financial Industry Regulatory Authority (FINRA), the U.S. Securities and Exchange Commission (SEC) and various state securities regulators. In addition, companies with SEC-registered securities are regulated by the SEC. OTCM does not regulate the OTC marketplaces. It is neither a stock exchange nor self-regulatory organisation (SRO) and is not itself regulated by FINRA or the SEC. The trading system is operated by OTC Link LLC subsidiary as a FINRA broker-dealer and registered with the SEC as an Alternative Trading System (ATS).

On 8 March 2013 the SEC announced closer regulation of systemically important ATSs which include OTC LINK ATS and as such would be subject to closer regulation. While this will incur some incremental cost for OTCM, it also further enhances the group's credibility.

FINRA proposed Quotation Consolidation Facility (QCF)

On 13 November 2009, FINRA filed with the SEC a proposed rule change (QCF) whereby FINRA would provide a national best bid or offer for OTC securities and requiring OTCM to provide it with free quotations. These proposals would severely affect market data licensing revenues by eliminating the subscription income currently earned for distributing such data (nearly half the reported market data licensing revenues, or about a sixth of group revenue). In addition, there may be some negative impact on deals routed through OTC Link ATS, thus reducing trading services revenues, harming the value of OTCM's market data. Without management action, group profitability would be minimal.

There is no timeline for the when QCF may or may not be imposed. Small amendments were proposed on 18 March 2010, but neither they nor the original proposals have been adopted. We understand for proposals that have been with the SEC for this length of time, it is quite possible there will be a further round of seeking comments before anything is finalised. We also note that since the proposals were suggested OTC Link ATS has become a FINRA member broker-dealer, and a systemically important SEC regulated Alternative Trading System. As it is now regulated, many of the original reasons for putting the proposals forward should moderate.

OTCM has a variety of options if they are adopted, and in public releases has highlighted that it could bring a legal action against the SEC and/or FINRA. During the legal process it is probable that an injunction would be given, meaning that the current rules would continue to apply until the legal process was completed. OTCM believes much of the preparation work has been done by its lawyers during previous lobbying, somewhat moderating its potential costs. We also understand that OTCM would not be liable for FINRA's costs if it lost. However, any legal action could be protracted and costly, and could fail.

Other regulatory developments

- Jumpstart Our Business Startups Act/Dodd-Frank Wall Street Reform/Consumer protection act – some provisions of these developments could prove helpful to OTCM by increasing the number of securities trading on its marketplaces. Many small companies miss out on the advantages of traded shares because of compliance costs and complexities. If these are eased, there will be greater demand to have tradable securities and OTCM is the low-cost option.
- At the same time, regulatory burdens are a factor in choosing OTCM over listing markets and the easing of some of these rules for larger companies could see companies continue to list with exchanges rather than use OTCM. OTCM has noted that the easing of regulations had not seen a weakening of demand for its services, suggesting that its low-cost model is still a key attraction for its (potential) customers.

- On 14 October 2011, the SEC published FINRA's proposal to amend Rule 6433 (the "Tier Size Proposal"), which requires minimum quote sizes by an OTCM broker-dealer. The rule reduces tier sizes, and the number of tiers from nine to six. Management believes that the tier size reduction would degrade market quality and have a longer-term adverse effect on OTC Link ATS.

Competition

OTC Bulletin Board (OTCBB)

FINRA-owned OTCBB provides access to more than 3,300 securities and has more than 230 participating broker-dealers. We understand technology constraints, some potentially ill-judged pricing and management distracted for some years by uncertainty over a potential sale mean OTCBB has been losing business to OTCM. OTCM estimated that the number of quotes on OTCBB in 2006 was c 40k against OTCM's c 25k. The figures at end 2012 were 70k for OTCM and c 1k for OTCBB.

BX Venture Market

On 6 May 2011 the SEC approved the creation of the BX Venture Market (BXVM), a proposed listing market for OTC equity securities to be operated by NASDAQ OMX Group, Inc. Companies listed on the BXVM must be SEC-registered, be current in their reporting, and meet corporate governance standards similar to the listing requirements on the NASDAQ Stock Market, although the quantitative listing standards will be less stringent than those imposed on NASDAQ-listed companies. BXVM could thus compete for some companies traded on OTCQX U.S. and OTCQB marketplaces. In 2011 NASDAQ OMX Group announced that the BX Venture Market was expected to launch during 2012, however no specific plans were disclosed and nothing happened. BXVM's website reports the project is on hold (www.bxventure.com/faq/). While not carrying NASDAQ's brand, we believe OTCM has some key advantages over this venture: (i) it is an established first mover with market credibility, and (ii) it does not require large-company style corporate governance. We would expect it to take some time before BXVM has a noticeable impact on OTCM, and this will allow management time to react if the competitive threat proves more than illusory.

Exchanges/ATSs

While not an exchange, OTCM is competing for a share of securities trading with exchanges such as NASDAQ and NYSE, as well as international exchanges and is sensitive to their regulation as well as its own. Regulation of exchanges and their strategic direction could change the competitive environment. The more successful that OTCM is, the greater the probability that the exchanges will view its market as more attractive and look to establish me-too marketplaces backed by the exchange's infrastructure. This has not happened yet and NASDAQ has yet to go live with a proposed competitor after announcing its establishment some years ago. At present the other registered alternative trading systems provide execution services rather than quotation services and are more customers than competitors of OTCM. Private securities markets such as Secondmarket and SharesPost could evolve as competition. Management notes Secondmarket is trying to develop a market for community banks.

Technology

While OTCM provides a marketplace in securities, it is critically a systems business with in-house product development ensuring management has direct control. Continued reinvestment in systems is a feature of the business model that we expect to continue. OTCM is now electronically linked to traders also interfacing with the major exchanges, and delivery of service consistent with the technology requirements of this group has been a key feature of OTCM, creating an effective barrier to entry. Continuous re-engineering also reduces the risk that key staff move to potential competitors. Downtime has been negligible (operational availability 99.998% during 2012) and largely associated with connectivity with external networks. Legally OTCM is not liable to pay any compensation for downtime, although it obviously would affect the group's brand and reputation.

Other sensitivities

Stock liquidity

Officers and directors beneficially owned 4.6m shares with the CEO holding 3.4m class A and 130k Class C directly. In addition his family trust owns 687k shares and a further 11% is held by one holder (WP Carucci). The shares are concentrated in just 118 holders of record. Trading is limited (an average of 8,000 shares per week in 2012) creating illiquidity issues and share price volatility as holders may want to sell a reasonable block of shares or buyers look to execute a large purchase. The company maintains a share buyback programme with current authorisation to purchase over 250,000 additional shares.

2010 restatement of results

In August 2010 OTCM identified that $1.4m of accounts receivable generated in the market data licensing business from 2003-08 was uncollectable and so wrote it off. The problem arose from third-party vendor reported sales and historically poor internal controls. These have been addressed with, inter alia, new accountants, new CFO, new controller and a new collections system. We note the total accounts receivable (ex Bloomberg) due in the market data licensing business is under two months of revenue. The charge for bad debts in 2012 was c 50% the level of 2011 and 0.7% total revenue.

Valuation

On our estimates, OTCM is trading on a 2013e P/E of 14x for a business expected to deliver profit growth of c 16% over the next two years. There are no peers on which to value OTCM. Our Gordon's growth valuation model implies a value of $9.8 based off a sustainable ROE of 20% (c 5% below 2012 level), a cost of equity of 9% and growth of 5%. Our cash flow approach (taking explicit forecasts for two years, 10 years on an assumed 5% growth, 9% discount rate and terminal value at 10x final cash flow, generates a value of $11.5. While not peers, investors may note that NASDAQ OMX trades on a 2013 P/E of 11.8x, NYSE Euronext on 16.4x, Deutsche Boerse on 12.5x and the LSE on 14.1x.

Financials

Despite the financial crisis, OTCM has grown revenue every year since 2007, a trend we expect to continue. We expect both data-related and issuer services to grow (the latter noting an above-average attrition rate at the start of 2013 offset by management initiatives to up-sell to existing clients and continued growth in international corporates) and a recovery in trading services to a more normal market growth and with less attrition in broker numbers. We are forecasting 12% revenue growth (compared with 14% over past four years), which is up on 2012 growth, which suffered a nominal drop in trading revenue. We forecast the steady improvements in cost income ratio since 2010 will continue, and so have grown costs at 11%, 1% slower than revenue. In 2012 we see a period of IT investment and higher compliance costs, offset by some lower employment related costs. Should market conditions mean revenue growth is slower than we forecast, we expect management to pace investment accordingly. These forecasts make the group very capital and cash generative.

Exhibit 4: Key Financials – profit and loss ($000s)

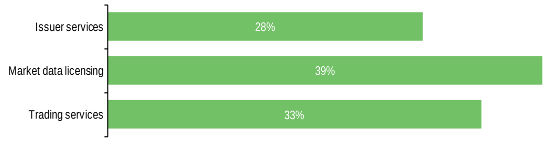
Year ended December	2009	2010	2011	2012	2013e	2014e
Trading Services	9,894	11,378	11,773	11,640	12,571	13,577
Market data licensing	10,911	11,858	13,111	13,555	14,911	16,402
Issuer services	3,227	4,803	8,067	9,831	11,797	14,157
Gross revenues	24,032	28,039	32,951	35,026	39,279	44,135
Re-distribution fees and rebates	(1,944)	(2,168)	(2,188)	(1,842)	(2,026)	(2,229)
Net revenue	22,088	25,871	30,763	33,184	37,253	41,906
Operating expenses (exc depreciation and amortisation)	(15,520)	(19,723)	(22,299)	(22,606)	(25,000)	(27,750)
Depreciation and amortisation	(835)	(1,017)	(1,358)	(1,622)	(1,800)	(2,000)
Income from operations	5,733	5,131	7,106	8,956	10,453	12,156
Other income / net interest	(89)	(69)	(115)	30	0	0
Income before provision for income taxes	5,644	5,062	6,991	8,986	10,453	12,156
Taxes	(2,138)	(2,127)	(2,139)	(3,509)	(4,181)	(4,863)
Net income	3,506	2,935	4,852	5,477	6,272	7,294
Diluted Adjusted EPS ($)	0.33	0.28	0.45	0.51	0.58	0.67

Source: OTC Markets, Edison Investment Research

Exhibit 5: Key Financials – Balance Sheet ($000s)

Year end December	2009	2010	2011	2012	2013e	2014e
Current assets						
Cash and Cash equivalents	5,385	6,703	10,170	13,611	18,963	24,596
Short term instruments	0	0	1,297	0	0	0
Accounts receivables net of allowances	5,861	5,329	7,194	6,481	7,000	7,750
Pre-paid income taxes	215	582	307	345	450	500
Prepaid expenses and other current assets	652	381	417	744	744	744
Deferred tax assets (net)	102	259	293	203	203	203
Total current assets	12,215	13,254	19,678	21,384	27,360	33,793
Property and equipment (net)	4,021	4,036	5,143	5,066	5,066	5,066
Goodwill	251	251	251	251	251	251
Intangibles	139	88	40	40	40	40
Security deposits	89	181	209	209	209	209
Deferred tax assets (net)	0	0	0	0	0	0
Total Non-Current assets	4,500	4,556	5,643	5,566	5,566	5,566
Total Assets	16,715	17,810	25,321	26,950	32,926	39,359
Current liabilities						
Accounts payable	791	387	629	721	600	600
Current portion of bank loan	786	92	0	0	0	0
Accrued expenses and other	2,180	1,970	3,066	2,868	3,000	3,000
Dividend payable	336	414	419	0	500	650
Income tax payable	0	0	0	0	0	0
Income tax reserve	0	372	109	0	0	0
Deferred revenue	2,731	4,299	6,628	7,670	8,670	9,670
Total Current Liabilities	6,823	7,534	10,851	11,259	12,770	13,920
Bank loan	1,246	0	0	0	0	0
Deferred rent	757	816	926	786	675	575
Deferred tax liabilities net	176	200	475	113	113	113
Income tax reserve	0	0	197	277	277	277
Total non current liabilities	2,179	1,016	1,598	1,176	1,065	965
Total Liabilities	9,002	8,550	12,449	12,435	13,835	14,885
Net assets Inc non-controlling interests	7,713	9,260	12,872	14,515	19,091	24,474
Year-end no of shares	8,408,942	10,480,945	10,615,433	10,830,885	11,030,885	11,230,885
Equity NAV per share ($)	0.917	0.884	1.213	1.340	1.731	2.179

Source: OTC Markets, Edison Investment Research

Contact details	Revenue by activity
304 Hudson Street 3rd Floor New York NY 10013 US +1 (212) 896 4400 www.otcmarkets.com	

CAGR metrics		Profitability metrics		Balance sheet metrics		Sensitivities evaluation	
EPS 2010-12	35%	ROE 2012	40%	Net cash 2012	$13.6m	Litigation/regulatory	●
EPS 2012-2014e	15%	Avg ROE 2010-2104e	27%	Net cash 2014e	$24.6m	Pensions	○
Revenue 2010-2012	13%	Pre-tax margin 2012	27%	CA/CL 2012	190%	Currency	◖
Revenue 2012-2104e	12%	Pre-tax margin 2014e	29%	CA/CL 2014e	254%	Stock overhang	●
Costs 2010-2012	8%	% revenue trad servs 2012	33%	Debtor days 2010	75	Interest rates	◖
Costs 2012-2014e	11%	Bad debts 2012	0.7%	Debtor days 2012	71	Equity markets	◖

Management team

CEO, president, director: R Cromwell Coulson	CFO: Wendy Fraulo
In 1997, Cromwell led a group of investors in acquiring OTCM's predecessor business, the National Quotation Bureau (NQB). Prior to this, Cromwell was an institutional trader and portfolio manager in distressed and value-oriented investments.	Wendy Fraulo joined as CFO in July 2011 after 12 years of public accounting experience including M&A transaction services at Deloitte & Touche LLP and previously audit work on large SEC registrants.
General counsel: Dan Zinn	
Dan joined in November 2010. Prior to joining OTCM, he was a partner at The Nelson Law Firm, LLC, outside counsel to the company. Dan previously worked in the corporate office of the American International Group (AIG).	

Principal shareholders	(%)
R Cromwell Coulson 3.413m direct ownership, (Family trust has an additional 0.687m)	31.9 (6.4)
WP Carucci (1.138m)	10.6
A Wimpfheimer (director 0.385m)	3.6
Other officers and directors beneficial ownership (0.763m)	7.1
R Cromwell Coulson Class C 131k	100%

Companies named in this report

NASDAQ OMX, NYSE Euronext, Deutsche Börse, LSE